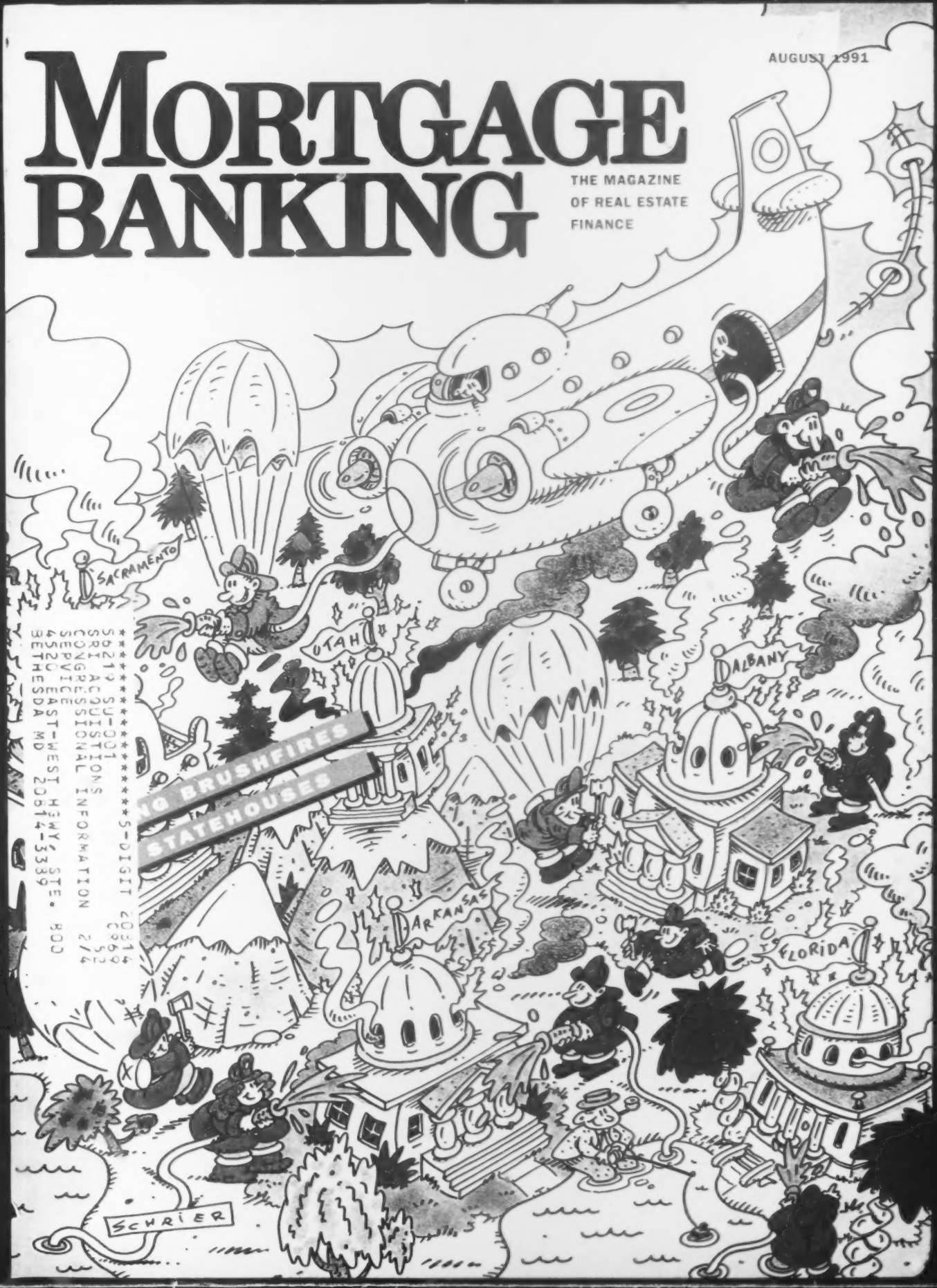
AUGUST 1991

MORTGAGE BANKING

THE MAGAZINE OF REAL ESTATE FINANCE



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COVER:
Legislation

The states have emerged as a crucial new legislative battleground for mortgage companies trying to compete nationwide. Statehouses around the country are continually passing laws to license mortgage bankers and brokers or adding nuances to old laws that make them much more than mere licensing vehicles. As a result, the legislative brushfires that must be doused every year have left the industry's lawyers with little down time.

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COVER ILLUSTRATION BY FRED SCHRIER

Smoke Jumping

The industry's legislative firefighters got a good deal of extra time on the front lines this year, particularly in places such as Sacramento and Albany. A unique deadline put a federal statute that has produced major progress in the private secondary market on the line in many key states.

In New York and California and elsewhere, lawmakers have been deciding just how risky mortgage securities are as an investment for insurance companies operating in their boundaries. The states were empowered to reverse a decision made by their federal brethren back in 1984, that top-rated MBS and certainly Fannie Mae and Freddie Mac securities are highly desirable and secure investments.

The U.S. Congress back then tipped its hat to the concept of state's rights and self-determination and gave the states until October 3 to override a federal law called the Secondary Mortgage Market Enhancement Act. Who would have known then that the deadline would come due right on the heels of a historic bust of the thrift industry and a real estate recession that has made real estate synonymous with swamp land in the eyes of large insurance companies. Yet, this is the exact moment when we find the states faced with a decision on whether to concur with the U.S. Congress, which back in 1984 said the right policy decision is to channel more capital into the mortgage capital markets. What's at stake here is what will happen if we replace what has been a highly successful experiment founded on a single, uniform law, with an unpromising return to a patchwork of state laws that no doubt will curtail growth in the jumbo secondary market.

This is but one of the statehouse battles that is being fought this year on the industry's behalf by teams of expert advocates. Many of these unseen battles will shape the way the industry works or doesn't work in the future.

Janet Reilley Hewitt
Editor in Chief

COMING IN SEPTEMBER

The September issue will focus on how accounting has become king in the mortgage business. The accounting standard setters have had their say and now it's time to hear what some mortgage bankers have to say about the accounting rules they most love to hate.

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CROSSING THE RUBICON

KPMG Peat Marwick's 1990 servicing performance study shows participants passed the $100-per-loan threshold on core cost. Here's the rest of the story behind this milestone.

Linda C. Simmons and Michele M. Long

The $94 core servicing cost reported in KPMG Peat Marwick's 1989 Mortgage Servicing Performance Study (MSPS) reflected a decrease in the cost of customer service, an increase in the cost of collection and foreclosure and a subsequent decrease in total servicing cost. The results suggested that the 1990 core servicing cost could go either way. The challenge for the 1990s was on.

> *"...Ancient history has it that it was considered an act of treason to enter Italy proper with an army over the Rubicon River. Of course, Julius Caesar did just that in 49 B.C. Since then, crossing the Rubicon is associated with making a statement...and dealing with the consequences..."*
>
> *unknown undergraduate, final exam, History 103*

The 1990 Mortgage Servicing Performance Study (MSPS) produced a weighted-average core cost of nearly $109 per loan. Participants in this year's study crossed the mythical servicing-cost Rubicon, reporting a 15 percent increase in core cost and a 17 percent increase in total cost (excluding amortization). The core-cost increase reflected the volume of difficulties in the industry; the total-cost increase was clearly a result of the cost of carrying these difficulties.

Notably, crossing the $100-per-loan-threshold was done amidst significant efforts to keep costs down. Noticeable changes in organizational structure, increased use of outsourcing, enhanced preservicing acquisition scrutiny and planning and investment in voice-response units, autodialers, imaging and other technology were but a few of the projects aimed at managing servicing core costs. There were noticeable differences between those functional areas where core costs benefit from increases in volume and those functional areas where core costs rise with added volume.

The KPMG Peat Marwick fifth annual MSPS covered more than 3 million loans with a dollar volume of $204 billion serviced. The average portfolio serviced per participant was more than 196,000 loans with an average balance of close to $70,000 per loan.

Data collection was focused on personnel (salaries, benefits, incentives and the like), operating (outsourced and non-reimbursed) expenses and other operating (occupancy, utilities and so forth) costs. Full-time equivalent (FTE) management and staffing were measured for productivity purposes. Noncore costs, performance and profitability results were derived from balance-sheet and income-statement information.

Portfolio characteristics were gathered to reflect industry trends and the impact of previous results on core cost. The increasing number of repeat participants coupled with participants new to the study provided a wealth of data for the fifth and most unique analyses.

The big picture

The weighted-average core cost, or the direct cost of servicing a residential mortgage loan across this database of 3 million loans was $108.68, or $109 per loan. The $15 or 16 percent increase over the average core cost finding under the 1989 study occurred also entirely within the collections and foreclosure function ($12, or 46 percent more than 1989) and ancillary functions ($4, or 15 percent over 1989). A 4 percent reduction in the cost of customer service was nearly offset by a 3 percent rise in the cost of investor services.

In 1990, ancillary functions, which include general administration, data

processing and the like, displaced customer service as the second-largest component of core cost. A comparison of the 1989 and 1990 core cost functional breakdown is presented in Chart 1.

The problems of delinquent loans were clearly reflected in total costs. The total servicing cost, which includes the core cost, loan losses, interest expense on advances plus indirect overhead, was $174 per loan, excluding amortization. This represents a $30, or 21 percent increase over 1989 results. In addition to the $15 increase in core cost, participants experienced a $10-per-loan increase in interest expense (a rise of 145 percent) over 1989, plus a $6-per-loan increase in loan losses. Indirect overhead allocation decreased compared to 1989. The relative distribution of 1989 and 1990 total servicing costs is shown in Chart 2.

Cost: at the crossroads

1990 core cost, as a percentage of total servicing costs, decreased over 1989's findings in that regard, suggesting that participants were better able

Crossing the $100-per-loan-threshold was done amidst significant efforts to keep costs down.

to manage their direct costs. Inflation appeared to have minimal impact on 1990 core costs. Both personnel and other operating costs decreased as a percentage of core cost compared to 1989, as shown in Chart 3.

Personnel costs per loan increased $5 per loan over 1989. This finding was a reflection of participant geography, rather than inflation or additional staffing. Personnel cost per FTE had a significant impact on overall core costs and was a relatively good predictor of core cost.

The increase in operating costs as a percentage of core cost (from 30 percent to 39 percent) suggested that the 1990 participants used more outside services in 1990. The $14-per-loan increase was supported by added costs in the foreclosure and real-estate owned (REO) functional areas, which experienced the most significant increases in operating costs.

Participants did an admirable job of controlling their other operating costs. Occupancy, telephone, postage and the like, experienced a $4-per-loan decrease.

Analysis of the 19 functional areas show that some trends isolated in past surveys are continuing, while the most recent results also show some new issues have emerged.

Five functional areas—foreclosure, data processing, REO, customer inquiry and general administration—accounted for 58 percent of core cost. In 1989, data processing, REO, general

CHART 1

Comparison of Core Cost-Functional Breakdown

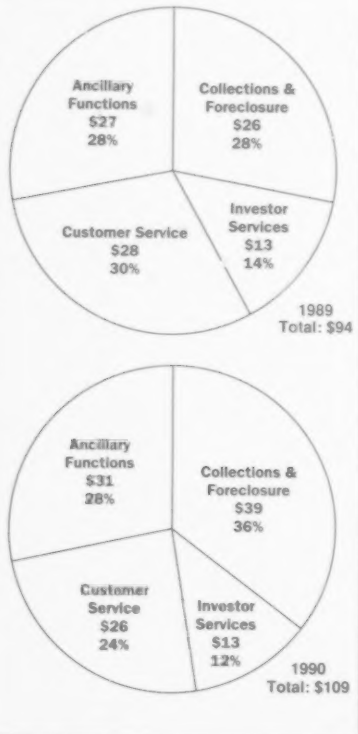

Ancillary Functions $27 28%
Collections & Foreclosure $26 28%
Customer Service $28 30%
Investor Services $13 14%
1989 Total: $94
Ancillary Functions $31 28%
Collections & Foreclosure $39 36%
Customer Service $26 24%
Investor Services $13 12%
1990 Total: $109

CHART 2

Distribution of Total Servicing Costs

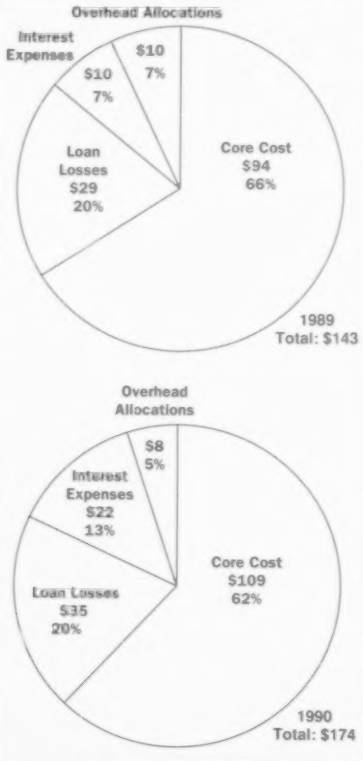
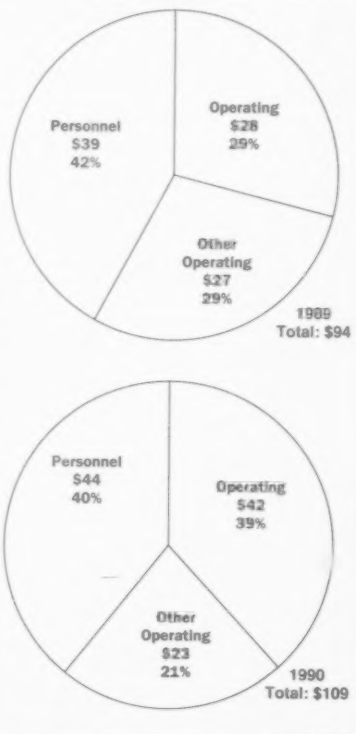


CHART 3

Personnel, Operating, Other Operating Cost Breakdown



administration, customer inquiry and collections accounted for 51 percent of the core servicing cost.

For the third consecutive year, the cost of customer service dropped, both as a percentage of core cost and in absolute dollars. The insurance function experienced the largest cost decline compared to 1989, followed by decreases in the tax, payoff and assumption functional areas.

The cost of servicing acquisition and special loans (including ARM adjustments) more than doubled over 1989 costs. Bankruptcy costs increased 40 percent compared to 1989 levels, although there was no relationship between bankruptcy ratios (the ratio of bankruptcies to total loans in the portfolio) and bankruptcy core cost.

Performance measures took a decided turn downward in the 1990 survey findings. For the fifth year, the average monthly number of loans serviced per FTE was a good predictor of core cost. However, the 1990 monthly average number of loans serviced per FTE of 630 reflects a decrease of 5 percent over 1989's average.

Surprisingly, the increase in collection and foreclosure costs was not reflected in increased staffing levels. For the third consecutive year, collection and foreclosure staffing levels declined as a percentage of total FTEs.

Turnover averaged 34 percent, an increase over 1989's ratio of 31 percent. Total turnover, as well as turnover by functional area, was not a predictor of core cost in the 1990 study.

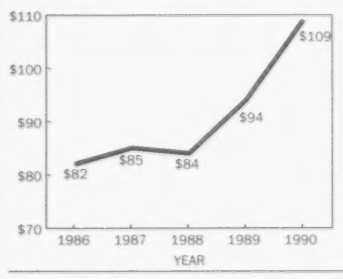
There was no apparent trend between span of control (staff to management ratios) and overall core costs.

In 1990, lower cost meant less

In the 1990 study, some of the most

CHART 4

Average Servicing Costs



Participants in this year's study crossed the mythical servicing-cost Rubicon, reporting a 15 percent increase in core cost and a 17 percent increase in total cost.

significant differences among servicing costs occurred between participant groupings of "low-," "mid-" and "high-" cost servicers, as calculated by their deviation from the weighted-average cost.

One of the most revealing facts was that the low-cost servicers had lower costs in each of the five largest functional areas: foreclosure, data processing, REO, customer inquiry and collections; however, the same servicers were not lower cost across all 19 functional areas. Conversely, the high-cost servicers were not the higher cost finishers across all functional areas, although they were the higher cost servicers for the five largest functional areas.

Some other characteristics that distinguished low-cost servicers from high-cost servicers included:

- Collections and foreclosure expenses accounted for 29 percent of core costs for the low-cost servicers. High-cost servicers, on the other hand, had 42 percent of their core costs coming from the collections and foreclosure area. Low-cost servicers had lower average delinquency, foreclosure and REO rates than high-cost servicers.
- Nearly 68 percent of foreclosure costs for the mid- and high-cost servicers were associated with outsourcing—the use of an outside provider of a particular service. The low-cost servicers incurred only 27 percent of their foreclosure costs with outside vendors. This suggests that low-cost servicers are doing more of the foreclosure processing themselves and managing their outside relationships more closely. Productivity results support this observation as foreclosures per FTE were about the same for low-, mid- and high-cost servicers.
- Although bankruptcy core costs were linear, bankruptcy ratios did not mirror bankruptcy core costs. It might seem reasonable that as costs rise there would be a corresponding rise in bankruptcies, but the 1990 MSPS did not find that to be true. Again, it appears that lower-cost servicers are performing more of the processing themselves and managing outside vendors, such as attorneys, more closely.
- REO costs clearly distinguished low-cost servicers from high-cost servicers. The low-cost servicers generally had REO rates significantly below average and thus also had lower costs in this area. Furthermore, many participants, low-, mid- and high-cost alike, became property managers with an average of almost 40 percent of REO costs allocated to property maintenance (net of reimbursements).
- Productivity followed the low-mid-high core cost relationship for the customer service and ancillary functions (the largest and third-largest FTE areas). This finding suggests that customer service and ancillary function core costs are affected more heavily by productivity than areas such as collections and foreclosure, where costs are driven by factors such as portfolio age and mix.

Another possible factor contributing to this theory is that the low- and mid-cost servicers had their most experienced management in the customer service and ancillary functions areas, coupled with the least experienced staff. Higher cost servicers had their most-experienced management and least-experienced staff in the collections and foreclosure area. They also

had 45 percent of their total personnel dedicated to this area.

- Consistent with 1989, low-cost servicers experienced growth in their portfolios, while higher cost servicers experienced net decreases in portfolio size.

Is bigger always better?

Participants were arbitrarily divided by 1990 average portfolio size into "larger" (more than 200,000 loans), "mid-sized" (between 125,000 and 200,000 loans) and "smaller" (less than 125,000 loans) servicing portfolios. Overall core cost ranged from $106 to $117 when moving from larger to smaller portfolios, representing a linear pattern.

However, the core cost for each of the four functional groupings (customer service, investor services, collections and foreclosure and ancillary functions) was hardly linear, suggesting that economies of scale exist within some of these functional groupings but not others. For example, the larger servicers had higher per-loan collection and foreclosure costs than either the mid-sized or the smaller servicers. However, the reverse was true for ancillary functions, where the larger servicers had lower per-loan costs than the mid-sized or smaller servicers.

The 1990 results also indicated that mid-sized servicers experienced a per-loan cost advantage in investor services while experiencing a per-loan cost disadvantage in customer services. This supports our theory that growth is felt unevenly across the key functional areas.

The ultimate challenge: profitability

There appeared to be several key factors in determining profitability for this year's study participants. Net portfolio change proved a good predictor for overall servicing profitability. Participants who experienced portfolio growth in 1990 were able to earn more income per loan than those who experienced portfolio shrinkage. The participants with the lowest net-servicing-income figures experienced portfolio shrinkage—the portfolios shrunk from a drop of 2,000 to upwards of 23,000 loans. Conversely, the highest servicing income participants experienced portfolio growth ranging from 13,000 to 36,000 loans.

Participants with high profit margins tended to have a larger number of loans originated in the previous two years (1989 and 1990). Consequently, these participants had a higher average principal balance outstanding than participants with portfolios dominated by older loans.

Net portfolio change proved a good predictor for overall servicing profitability.

Gross servicing fees accounted for 84 percent of total revenues, which gave a profitability edge to those participants with higher average principal balances outstanding. Ancillary income followed gross servicing fees, accounting for 10 percent of total revenues. Of the ancillary income accounted for in the 1990 study, 67 percent came from late charges collected, up 10 percent from 1989. This corresponded to the overall increase in delinquency rates (from 4.32 percent to 4.68 percent).

The study basics

Participants provided data in two forms. On a preformatted diskette, key cost accounting, productivity, operating, some balance sheet and profitability information was provided. Submitted in February, this data underwent several iterations of stringent review and validation, including preliminary graphical interpretation among participants. Nearly 3,000 cost, productivity, performance and profitability relationships were examined before selecting key results for presentation.

In written form, participants responded to profile, or qualitative, inquiries concerning servicing initiatives and projects, productivity and quality measures employed, capital and equipment investments, incentive programs and so forth. These profile results were summarized in table and matrix formats by participant and by functional area to provide a reference between the cost results and qualitative approach of the individual participants. For example, the data-processing cost results are followed by a complete matrix of data-processing systems, peripherals and the like, by participant.

Results of the data and profile analyses were provided to participants in mid-April. Participants also received an analysis depicting themselves against the average of each functional area in cost, salary, productivity and turnover. Specific functional areas were highlighted to signify how cost reduction in a given area would contribute to overall core-cost reduction. In addition, nearly all participants were visited during the data-collection or validation phases of the study to provide both participants and validators a better understanding of each participant's unique set of circumstances. Senior executives of participating firms met in early May to further analyze the results and to discuss how current trends are affecting their 1991 costs.

As the story goes, crossing the Rubicon was not the end of the line for Julius Caesar. History has it that he did well for a number of years after his crossing. The same is likely to be true for the mortgage servicing industry. While the $100 servicing-core-cost threshold has been crossed this year, 1990 remained a positioning year for the MSPS participants. Certainly, many are poised for lower servicing costs during 1991—hopefully they will slip back across the critical line. **MB**

Linda C. Simmons is a principal in KPMG Peat Marwick's Washington, D.C. office, and Michele M. Long is a senior manager in the Washington, D.C. office. Both Dr. Simmons and Ms. Long are active participants in the firm's national mortgage banking practice.

LENDING ASSISTANCE

Both secondary mortgage market giants, Freddie Mac and Fannie Mae, have established "targeted" affordable housing departments during the past few years. Each agency is quick to point out that these developments are part of their long-standing efforts in this regard, citing statistics and numerous earlier examples of their affordable housing activities. Each also will point to the average size of the mortgages they purchase as further evidence of their affordable housing efforts.

All these statistics, examples and average loan balances are true. Each organization has and is making a variety of efforts in this area. These efforts include cash equity investments, special mortgage underwriting guidelines, mortgage counseling programs and direct grants. The cumulative numbers are certainly substantial. Particularly, when you consider that the central mission of each organization is to help provide liquidity to the national mortgage market through linkage with the capital markets. In providing this linkage, each agency helps reduce the cost of mortgage credit. By reducing the overall cost of mortgage credit, Fannie Mae and Freddie Mac make housing more affordable for all Americans.

However, as Congress formulated legislation to address the savings and loan industry crisis, it also made changes to the charters of Freddie Mac and Fannie Mae. Hidden somewhat behind the publicity on Freddie Mac's new board of directors, behind the coverage devoted to which department of the government will regulate the secondary market giants and behind the headline-grabbing revisions to the regulation of the thrift industry, was the first direct mention of a responsibility to foster affordable housing on the part of the two agencies. The existing language in the charter of each organization now reads "...provide ongoing assistance to the secondary market for home mortgages (including mortgages securing housing for low- and moderate-income families involving a reasonable economic return to the Corporation)..." Fannie Mae already had created its Office of Low- and Moderate-Income Housing in September 1987, prior to passage of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) and Freddie Mac created its Affordable Housing Initiatives Department approximately one year after passage of the legislation.

In recent years, Fannie Mae and Freddie Mac have begun purchasing mortgages created under local affordable housing programs; making community reinvestment a more viable opportunity for lenders.

Tom R. Dalton

When asked what prompted Fannie Mae to create a separate department for affordable housing, Fannie Mae Senior Vice President of Low- and Moderate-Income Housing Initiatives Marty Levine said, "Fannie Mae has always felt [it] had a responsibility to support affordable housing." While acknowledging the legislation had some impact, Levine says, "Fannie Mae's creation of the department and increased efforts in this area in the 1980s is more a function of the improved profitability of the organization and the likelihood of that profitability continuing for the foreseeable future. As we became more profitable and could see that trend continuing, we could expand our targeted programs and outreach efforts."

Carl Riedy, Freddie Mac vice president for affordable housing initiatives, says the rationale for creating his department was fourfold.

- The growing impact of the secondary market on all facets of the mortgage industry.
- Increased Community Reinvestment Act (CRA) pressures on the agency's customers from regulators and recent legislation increased the requests for assistance in this area.
- Heightened awareness of housing affordability issues in general.
- Corporate charter changes generated by FIRREA.

Whatever the genesis, each organization now has a separate affordable housing initiatives department within

its corporate structure. The affordable housing department is a part of the marketing divisions inside each agency. The companies also have made affordable housing initiatives a specific marketing responsibility for their regional sales forces.

NATIONAL AFFORDABLE HOUSING PROGRAMS MUST AVOID FORCING SUCCESSFUL LOCAL INITIATIVES (SQUARE PEGS) INTO TIGHTLY STRUCTURED NATIONAL PROGRAMS (ROUND HOLES).

Overview of initiatives

Fannie Mae's low- and moderate-income housing initiatives can be divided into four broad categories: public finance, community lending, low-income rental housing equity investments and other special initiatives.

Public finance initiatives involve working with state and local housing finance agencies (HFAs) to reduce the cost of mortgages that are financed with mortgage revenue bonds. By selling bonds directly to Fannie Mae, HFAs can reduce their borrowing costs; making more funds available and at lower rates than would normally be possible. In this area, Fannie Mae is also providing credit enhancement for tax-exempt mortgage revenue bonds. This credit enhancement using Fannie Mae mortgage-backed securities makes the bonds eligible for "triple-A" ratings thus reducing the HFA's financing costs and simultaneously eliminating the need for pool insurance. These same techniques can be used for both home and multifamily bond issues.

Fannie Mae's community lending initiatives involve specially designed community lending programs fashioned in partnership with lenders, mortgage insurers, public agencies and nonprofit organizations. Typically these programs involve low down payments, reduced closing costs and more flexible qualifying ratios for borrowers. One significant feature is the "3/2 Option," where homebuyers meet the minimum 5 percent down payment requirement with 3 percent of the funds coming from their personal resources and up to 2 percent coming from a gift from a family member or a grant or unsecured loan from a nonprofit organization or public entity.

The low-income rental housing equity investments are corporate financial commitments to invest cash equity in low-income rental housing in exchange for federal tax credits. In order for projects to qualify for these tax credits, at least 20 percent of the units in each project must be set aside for low-income tenants for a period of not less than 15 years. Since 1987, Fannie Mae has committed $162.8 million to low-income tax-credit investments. (See Chart 1.)

Other special affordability initiatives at Fannie Mae include efforts such as demonstration projects to create models for the development of employer-assisted housing in high-cost markets; a special arrangement with the Mortgage Bankers Association of America (MBA) to provide debt or equity financing for rental housing projects in six different communities; and the annual Fannie Mae Foundation Awards for innovative community-development efforts.

Freddie Mac's initiatives are most easily differentiated by property type into separate homeownership and rental property strategies.

The homeownership strategy can be segregated further into targeted lender initiatives and public partnerships. In a sense, this division could be characterized as existing- and new-customer initiatives. The strategy is to work with targeted lenders (existing customers) to design and develop tailored programs that meet the needs of their community and marketplace. At the same time, Freddie Mac is working with public partnerships (new customers) such as state/local housing finance agencies and nonprofit organizations to help meet their needs in providing and maintaining affordable housing units.

Many of the tools and/or techniques used to further these strategies are similar with both groups. They include low down payments (typically 5 percent), reduced closing costs and flexible qualification requirements and alternative verification procedures for credit histories. A significant feature that has increasingly appeared in Freddie Mac programs is mandatory borrower counseling prior to and following loan closing. Pursuant to this, two major counseling seminars were held in mid-June sponsored in conjunction with the MBA and the National Low Income Housing Coalition (NLIHC).

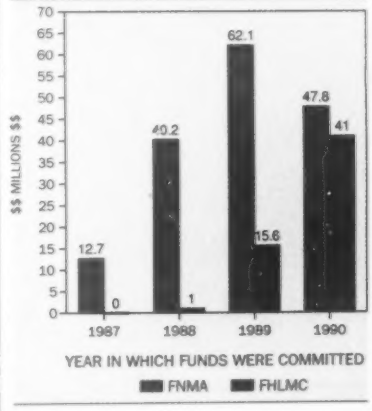
Freddie Mac's rental property strategy also has several components. The first of these is its low-income, rental, tax-credit equity investment activities. During the past three years, Freddie Mac has committed $57.646 million to these investments.

The second component of Freddie Mac's rental strategy was initiated earlier this year with the announcement of a two-year commitment in partnership with the National Community Development Initiative (NCDI). NCDI will operate through the country's two leading community development support organizations—the Local Initiatives Managed Assets Corporation (LIMAC) and The Enterprise Foundation. Under the terms of the agreement, LIMAC will purchase low-income rental housing mortgages from local lenders and sell those multifamily mortgages to Freddie Mac. Under this program, LIMAC will provide credit support for the mortgages as well as local community lending expertise. Freddie Mac's Riedy says, "I am hopeful that this agreement will act as a framework for similar ventures with other nonprofit organizations and foundations."

The final component of Freddie Mac's rental strategy is currently

CHART 1

Tax Credit Equity Investment
FNMA vs FHLMC



under development with an announcement anticipated by early 1992. The objective is to design a program to help preserve the existing inventory of low-income housing stock in this country. During the past two decades, a considerable supply of low-income housing stock has been generated through the HUD 236 program (Mortgage Insurance and Interest Reduction Payments for Rental Projects) and Section 8 housing assistance payments programs. Under these programs, projects were required to maintain units as low-income housing or had rents subsidized by Section 8 assistance contracts. During the next few years, the rental assistance contracts and low-income unit restrictions on these projects will be expiring. There is significant risk that with the expiration of these agreements, a large percentage of these units will become market-rate rentals. Riedy envisions Freddie Mac developing a program to help keep these units for low-income rental housing.

THERE IS SO MUCH THAT REMAINS TO BE DONE IN THE AFFORDABLE HOUSING AREA, FANNIE MAE AND FREDDIE MAC NEED NOT COMPETE FOR MARKET SHARE IN THIS BUSINESS.

Similarities

Now that we have discussed the nuances that distinguish the two agencies approaches, what things are the two agencies doing alike? Each organization is:

- investing equity in low-income, rental housing, tax credits.
- working with lenders, mortgage insurers, housing finance agencies, public agencies and nonprofit organizations to develop programs and initiatives defined by local markets and needs.
- engaged in joint initiatives with organizations such as the LIMAC, the Enterprise Foundation and the MBA.
- making affordable housing initiatives a responsibility of its regional marketing staff.
- tracking separate risk elements on all affordable housing purchases in order to develop national databases.

There are also a number of similarities in the underwriting terms and flexibilities that have been used in home mortgage commitments.

- Generally, 5 percent down payment requirements are allowed. Fannie Mae and Freddie Mac have allowed 2 percent of the 5 percent down payment to be in the form of a loan from a family member or grant from a nonprofit organization. Freddie Mac has also allowed in at least one commitment that an additional 1 percent of the 5 percent down payment could be in the form of sweat equity.
- Qualification ratios are typically negotiated at 33 percent and 38 percent.
- Borrower liquidity reserves are often waived.
- Borrowers without substantial credit histories can generally establish verifications through nontraditional means, including utility companies or previous landlords.
- New homeowner counseling is often encouraged or required during pre- and post-closing.
- Gifts from family members can be used to pay closing costs.

Differences

Interestingly, even within these similarities there are differences. For instance, both Fannie Mae and Freddie Mac have invested in low-income rental-housing tax credits. Freddie Mac's investment began later than Fannie Mae's but there are differences beyond just timing. One hundred percent of Freddie Mac's tax credit investments have been in funds where they are one of several investors and the fund always involves multiple properties. By comparison, approximately 40 percent of Fannie Mae's tax credit investments have involved single assets, where Fannie Mae was the sole limited partner. These differences may be explained, in part, to timing. Fannie Mae's Levine explains, "When we made our initial tax-credit commitments, the tax-credit marketplace wasn't as developed as it is today. As a result, the investments that were available early on were nearly all single asset and sole limited partnerships." However, each organization does have a policy prohibiting its involvement in debt purchases when it is also an equity investor. Curiously, there has been at least one transaction where Freddie Mac and Fannie Mae were limited partners in the same transaction.

Other differences include Fannie Mae's significant efforts in purchasing and providing credit enhancement for mortgage revenue bonds, an area with which Freddie Mac has yet to become involved. Fannie Mae has assembled a home office and regional staff in the affordable housing area of approximately 40 people. Freddie Mac currently has seven staff members devoted to these efforts, all in the corporate headquarters. "We have made the conscious decision to process and purchase affordable housing products through our existing business structures and systems," says Riedy of Freddie Mac. "We are currently training our existing regional staff, and feel confident we can accomplish our objectives in this manner."

Helping the locals

This article has devoted only limited attention to transaction volumes. This was intended for a number of reasons. First, as indicated earlier, there are timing issues that would skew calendar-year and total-production comparisons. Second, the strategies used by the two organizations make direct comparisons difficult.

The primary focus of this article has been to show similar and different approaches the two secondary market agencies are taking in affordable housing. In terms of similarities, there are two statements with which both organizations will agree. First, there is so much that remains to be done in the affordable housing area, Fannie Mae and Freddie Mac need not compete for market share in this business. Second, to be successful, national affordable housing programs must be flexible, tap the expertise of local programs, and avoid forcing successful local initiatives (square pegs) into tightly structured national programs (round holes). **MB**

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ECONOMIC TRENDS

There is a widespread perception that housing affordability is a significant stumbling block to homeownership in the U.S., but there have been few studies that have documented the extent of the problem. For this reason, a new Census Bureau study, *Who Can Afford to Buy a House?*, by Census Bureau economists Peter J. Fronczek and Howard A. Savage, is an important contribution to the literature.

In it, the authors use detailed data on assets, debt and income in the late 1980s to determine whether families or individuals could qualify for the purchase of a home in their region using conventional or FHA financing. The results are enlightening.

Table 1 shows the factors that would prevent families and individuals from qualifying for the purchase of a median-priced home in their region and a modestly priced home using conventional fixed-rate financing. The median-priced home is the price at which half the homes in the region cost more and half cost less. A modestly priced home is defined as a home priced so that three-fourths of the homes in the region cost more and one-fourth cost less.

TABLE 1

Factors Preventing the Purchase of a Home
[Percent of Total Who Cannot Afford to Purchase Using Conventional Fixed-Rate Financing]

		Home Price	
		Median Priced Home	Modestly Priced Home
	Owners (Number in Millions Who Cannot Afford)	22.6	15.6
Percent Distribution by Reason Cannot Afford:			
	Cannot Afford Down Payment	48.1%	33.9%
	Cannot Afford Monthly Payments	5.9%	11.1%
	Debt Level Too High	7.6%	19.1%
	Combination of Reasons	38.5%	36.0%
	Renters (Number in Millions Who Cannot Afford)	34.3	32.2
Percent Distribution by Reason Cannot Afford:			
	Cannot Afford Down Payment	8.0%	5.5%
	Cannot Afford Monthly Payments	6.0%	12.4%
	Debt Level Too High	4.3%	11.1%
	Combination of Reasons	81.7%	71.0%

Source: U.S. Bureau of the Census

TABLE 2

Comparison of Affordability Using Conventional or FHA Financing
[Millions]

	Home Price	
	Median Priced Home	Modestly Priced Home
Total Who Cannot Afford:		
Using Conventional Financing	56.9	47.8
Using FHA Financing	54.9	44.9
Differences Between Conventional and FHA	2.0	2.9

Source: U.S. Bureau of the Census

Of current owners, about 22.5 million could not qualify for the median-priced home, and of these, around 15.5 million could not qualify for the modestly priced home. These figures partly reflect the fact that many current owners live in homes priced below the modestly priced home, but the numbers also reflect changes in the financial circumstances of current owners since the time they bought their home. For example, they may have been working when they purchased, but now they are retired—a change in life circumstances that may lead to disqualification for insufficient current income.

In the case of the median-priced home, the down payment hurdle is the most significant reason current owners could not qualify—accounting for more than 48 percent of those who could not qualify. This is an impressive share considering that equity in their current home would be available for the down payment, and still would not be enough to get them into the median-priced home. Disqualification on multiple factors was a close second, accounting for 38.5 percent. The numbers are similar for a modestly priced home, with the down payment hurdle accounting for nearly 34 percent of those who could not qualify, and multiple factors accounting for another one-third.

In the case of renters, more than 34 million could not qualify for the median-priced home, while more than 32 million could not afford the modestly priced home. In both cases, the overwhelming majority of renters who could not qualify could not do so for a combination of reasons. In short, it was not a single affordability constraint that would prevent most renters from qualifying, but several affordability constraints involving some combination of insufficient funds for down payments, insufficient income and/or too much debt.

In the late 1980s, though, the FHA program helped mitigate affordability problems significantly. Table 2 shows how many more families and individuals could qualify for home purchases using FHA financing compared to conventional financing. In the case of median-priced homes, more than 2 million more families and unrelated individuals could qualify; in the case of modestly priced homes, the number jumps to nearly 3 million.

The implication is clear. The FHA program provided vital opportunities for homeownership in the late 1980s. Unfortunately, the reforms to the FHA program so far in the 1990s unquestionably reduce opportunities for homeownership. When the Census Bureau updates this study several years from now, and reports affordability using current FHA financing requirements, it will be distressing to see just how significant the reductions in opportunities have been.

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VITAL STATISTICS

Key Economic Indicators and Interest Rates

	Changes in Payroll Employment (Thousands)	Unemployment Rate (%)	Changes in Consumer Prices from Year Ago Levels (%)		Mortgage Interest Rates (%)		
			All Items	All Items Less Food and Energy	Secondary Market Yield on FHA New Home Mortgages[1]	FHLMC ARMs	FHLMC FRMs
JUNE-90	131	5.3	4.7	4.9	10.21	8.49	10.16
JUL-90	−166	5.5	4.8	5.0	10.15	8.43	10.04
AUG-90	−109	5.6	5.6	5.5	10.20	8.35	10.10
SEP-90	−47	5.7	6.2	5.5	10.26	8.28	10.18
OCT-90	−131	5.7	6.3	5.3	10.24	8.21	10.18
NOV-90	−221	5.9	6.3	5.3	10.02	8.10	10.01
DEC-90	−140	6.1	6.1	5.2	9.74	7.93	9.67
JAN-91	−203	6.2	5.7	5.6	9.62	7.74	9.64
FEB-91	−258	6.5	5.3	5.6	9.58	7.65	9.37
MAR-91	−258	6.8	4.9	5.2	9.59	7.47	9.50
APR-91	−166	6.6	4.9	5.1	9.61	7.38	9.49
MAY-91	119	6.9	5.0	5.1	9.62	7.22	9.47
JUNE-91	−50	7.0	NA	NA	NA	7.24	9.62

Rates on Selected Securities (%)

	Federal Funds Rate	Prime Commercial Paper (3-Month)	U.S. Government 6-Month	U.S. Government 1-Year	U.S. Government 3-Year	U.S. Government 10-Year	A-Rated Utility
JUN-90	8.29	8.14	7.63	8.10	8.40	8.48	9.85
JUL-90	8.15	7.99	7.52	7.94	8.26	8.47	9.96
AUG-90	8.13	7.88	7.38	7.78	8.22	8.75	10.29
SEP-90	8.20	7.96	7.32	7.76	8.27	8.89	10.28
OCT-90	8.11	7.98	7.16	7.55	8.07	8.72	10.23
NOV-90	7.81	7.91	7.03	7.31	7.74	8.39	10.07
DEC-90	7.31	7.80	6.70	7.05	7.47	8.08	9.95
JAN-91	6.91	7.10	6.28	6.64	7.38	8.09	9.83
FEB-91	6.25	6.49	5.93	6.27	7.08	7.85	9.54
MAR-91	6.12	6.41	5.92	6.40	7.35	8.11	9.58
APR-91	5.91	6.07	5.71	6.24	7.23	8.04	9.46
MAY-91	5.78	5.92	5.61	6.13	7.12	8.07	9.45
JUNE-91	5.90	6.11	5.75	6.36	7.39	8.28	9.53

CURRENT SECONDARY MARKET YIELDS (%)

	GNMA[2]	FNMA[2]	FHLMC[2]	SPREADS (Basis Points) GNMA Minus 10-Yr. Govt.	FNMA Minus 10-Yr. Govt.	FHLMC Minus 10-Yr. Govt.
JUN-90	9.73	9.73	9.72	125	125	124
JUL-90	9.66	9.66	9.66	119	119	119
AUG-90	9.80	9.75	9.75	105	100	100
SEP-90	9.86	9.79	9.73	97	90	84
OCT-90	9.84	9.80	9.69	112	108	97
NOV-90	9.63	9.66	9.54	124	127	115
DEC-90	9.22	9.27	9.16	114	119	108
JAN-91	9.17	9.24	9.12	108	115	103
FEB-91	8.81	8.86	8.77	96	101	92
MAR-91	9.00	9.03	8.93	89	92	82
APR-91	8.95	8.98	8.88	91	94	84
MAY-91	8.94	8.95	8.86	87	88	79
JUNE-91	9.15	9.17	9.06	87	89	78

LENDER ACTIVITY

LONG-TERM MORTGAGE LOANS CLOSED
By Type of Institution and By Type of Unit
(Millions of Dollars)

	1-4 UNITS					5+ UNITS					NONRESIDENTIAL				
	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies	Total[3]	Mortgage Bankers	Savings & Loans[4]	Commercial Banks	Life Companies
JUN-90	38,428	9,714	13,209	15,063	29	2,778	209	989	682	182	16,411	105	666	12,303	3,097
JUL-90	35,524	9,627	12,020	13,461	30	2,082	165	871	696	209	16,222	98	476	12,525	2,984
AUG-90	35,777	10,359	12,940	12,032	34	2,582	106	950	1,243	92	18,967	107	650	14,783	2,994
SEP-90	34,210	9,825	10,617	13,347	36	2,008	178	855	608	112	20,231	102	577	16,100	3,343
OCT-90	35,229	12,128	11,317	11,395	37	1,719	41	843	606	28	13,941	99	551	10,049	3,041
NOV-90	32,595	13,104	8,750	10,361	43	2,074	211	669	887	122	16,352	92	580	12,321	3,288
DEC-90	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA

HOUSING ACTIVITY

RESIDENTIAL STRUCTURES

(Units in Thousands, Seasonally Adjusted Annual Rates)

	BY TYPE OF UNIT						BY REGION							
	HOUSING STARTS			BUILDING PERMITS			HOUSING STARTS				BUILDING PERMITS			
	Total	1-4 Units	5+ Units	Total	1-4 Units	5+ Units	Northeast	Midwest	South	West	Northeast	Midwest	South	West
JUN-90	1,187	931	256	1,123	850	273	114	241	532	300	124	229	425	345
JUL-90	1,155	907	248	1,086	839	247	115	226	492	322	115	228	421	322
AUG-90	1,131	865	266	1,055	817	238	122	240	434	335	114	221	405	315
SEP-90	1,106	893	213	989	778	211	104	239	445	318	111	218	385	275
OCT-90	1,026	861	165	925	747	178	144	230	392	260	114	194	360	257
NOV-90	1,130	823	307	916	710	206	147	232	483	268	108	194	366	248
DEC-90	971	768	203	854	689	165	110	233	395	233	99	181	338	236
JAN-91	847	677	170	802	651	151	86	167	361	233	96	188	306	212
FEB-91	992	825	167	876	739	137	91	301	384	216	99	205	353	219
MAR-91	907	770	137	892	734	158	104	226	390	187	96	204	340	252
APR-91	981	840	141	913	787	126	96	238	397	250	102	210	361	240
MAY-91	982	864	118	979	798	181	113	217	367	285	106	224	383	266
JUNE-91	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA	NA

HOME SALES

(Units and Prices in Thousands)

	EXISTING HOMES		NEW HOMES		
	Sold (SAAR)	Median Sales Price (Dollars)	Sold (SAAR)	Median Sales Price (Dollars)	Months Supply At Current Sales Rate
JUN-90	3,370	98.9	549	125.0	7.9
JUL-90	3,320	98.1	541	118.7	8.0
AUG-90	3,410	97.2	525	118.4	8.1
SEP-90	3,160	94.4	504	113.0	8.4
OCT-90	3,070	92.9	465	120.0	8.7
NOV-90	3,150	92.0	480	118.9	8.2
DEC-90	3,130	91.7	464	127.0	8.4
JAN-91	2,900	95.6	414	117.9	9.3
FEB-91	3,160	94.0	488	119.9	8.0
MAR-91	3,220	98.2	491	122.9	7.5
APR-91	3,310	100.3	490	120.0	7.5
MAY-91	3,510	99.7	474	121.9	7.8
JUNE-91	NA	NA	NA	NA	NA

VALUE OF NEW PRIVATE CONSTRUCTION PUT IN PLACE

(Units in Billions of 1987 Dollars, Seasonally Adjusted Annual Rates)

	Total[5]	1-Unit	2+ Units	Nonresidential
JUN-90	307.5	99.4	17.3	108.3
JUL-90	309.1	97.3	17.1	112.5
AUG-90	301.3	95.3	17.4	106.6
SEP-90	296.7	92.8	16.9	105.6
OCT-90	291.3	90.9	16.7	102.6
NOV-90	285.2	88.0	16.1	100.0
DEC-90	280.6	85.7	16.9	98.5
JAN-91	274.1	81.8	16.3	95.0
FEB-91	270.9	78.6	15.6	96.1
MAR-91	264.5	76.3	15.4	93.3
APR-91	268.4	76.6	14.4	97.6
MAY-91	263.9	80.1	14.1	90.2
JUNE-91	NA	NA	NA	NA

NA—Not Available; SAAR—Seasonally Adjusted Annual Rate

[1]Secondary market gross yields. Numbers shown for each month are the average of yields from the first day of the month shown and the first day of the subsequent month.

[2]Securities for 0- to 30-day delivery.

[3]In addition to the categories shown, the total also includes private pension funds, private MBS conduits, state and local retirement funds, federal credit agencies, mortgage pools, and state and local investment agencies.

[4]Savings & Loans and Mutual Savings Banks.

[5]In addition to the categories of private construction shown, the total also includes these categories: residential improvements, railroads, electric light and power, gas, telephone and telegraph, petroleum pipelines, and farm nonresidential.